



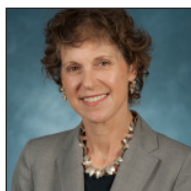
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Designing and Enforcing Effective Financial Regulation



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Since the 2007-2009 financial crisis, regulators often speak of “macro-prudential regulation”, but the term has not translated into reliable tools that make the system safer. Despite the flurry of action, too little has changed. Some of the new regulations are too complex and costly, while their benefits are questionable. At the same time, simpler steps to reduce the opacities, distortions and risks in the financial system are overlooked.

Examples illustrate the issues. Under Title 1 of the USA’s Dodd-Frank Act, large banking institutions must submit “living wills” to establish that they can go through bankruptcy without harming the economy. Complying and enforcing this regulation is extremely costly for the institutions and for regulators. The institutions produce thousands of pages, which regulators must read and evaluate. But the benefits so far seem too small to justify the costs.

It defies credibility to claim that institutions much larger and more complex and “systemic” than Lehman Brothers was in 2008, and which are funded with enormous amounts of fragile short-term debts and have derivatives positions in the trillions of dollars, can go through bankruptcy without causing harm. The institutions actually don’t know enough about their counterparties’ investments and funding to predict what would happen in each of the many possible scenarios associated with their own presumed bankruptcies.

Regulators are also not in a position to foresee the complex

ripple effects that might accompany the failure of a major institution. The system is too opaque and interconnected to be certain of how markets and investors would behave. Scenarios in which large institutions file for bankruptcy are likely to come at the same time as the weakening, or indeed cause the weakening, of many of their counterparties, possibly the entire system. Contractual and legal provisions in derivatives and repo agreements, off-balance-sheet commitments, and the breakdown of markets are likely to create major instabilities.

Failures of large institutions through bankruptcies or alternative resolution mechanisms are particularly complicated for those operating in numerous countries with different regulatory and legal regimes. The Financial Stability Board produced a detailed document outlining the desired “key attributes” of effective cross-border resolution, but the implementation of the numerous recommendations, which often require changes in laws, is unlikely to be completed any time soon. The International Monetary Fund assessed recently that the orderly failure of large global financial institutions is, as of now, “not a viable option”. Even within Eurozone nations attempting to create a banking union, the effort to create a reliable resolution mechanism has just begun.

The Dodd-Frank Act gives regulators plenty of authority to take action if living wills are unsatisfactory. If living wills are evaluated properly, large banks cannot credibly pass them. Nevertheless, after multiple submissions by the largest banks, regulators have not admitted the futility of the exercise and have not taken specific steps to address the problems. They have asked institutions to improve their submissions a year later, allowing more time to go by. Quite clearly, at this point the living wills regulation has been a wasteful charade with minimal benefits. When other companies simplify their structures, they often do so because of pressure from investors. But such forces do not exist in banking, and only effective laws or regulations can bring about change.

A thorny issue in trying to make the failure of large financial institutions less harmful is who will actually trigger the “fail” scenario and on what basis. Will the fail scenario entail the institution defaulting on its debt? Will central banks offer “liquidity supports” to prevent defaults or funding withdrawals ahead of a possible failure? The notion of insolvency, meant to capture an “inability” to pay, is vague and requires judgement as to the value of assets, which is extremely complicated for complex and opaque financial institutions. Policymakers may be too concerned with the potentially harmful consequences, or delay triggering the failure until harm actually materializes and failure seems too costly. Thus we may well see government bailouts and massive supports from central banks when a large

institution appears to be near failure.

The anticipation of such support enables and rewards recklessness, even lawlessness, on the part of banks and individuals within the banks. Repeated scandals involving fraud, manipulation, and other wrongdoing suggest that the largest institutions suffer from severe governance problems and that accountability and controls are lacking. Most stakeholders, including shareholders, are harmed, but executives and traders benefit and suffer little personal consequences for wrongdoing.

Basel II, the previous international agreement on minimal regulation for bank stability that has so clearly failed, considered many hybrid funding sources, such as unsecured long-term debt that in principle could absorb losses in some scenarios, to count as “regulatory capital”. Yet during the financial crisis of 2007-2009, none of the holders of those securities (except in the case of Lehman Brothers) actually suffered losses, even in institutions that received massive bailouts. All debt promises were paid in full.

Nevertheless, we are now asked to trust a new generation of debt-like hybrid securities dubbed Total Loss Absorbing Capacity (TLAC) or contingent capital (CoCo) to replace government bailouts with “bail-ins” by investors. A recent agreement requires globally systemic institutions to issue significant amounts of such securities. But TLACs only absorb losses when an institution fails and becomes a “gone concern”, essentially within a resolution process. The trigger event may set in motion similar contagion mechanisms that may lead to instability and crisis. Determining when to trigger the bail-in is difficult, and the concern with the impact of the losses on TLAC holders and others may scare policymakers away from triggering it.

Designing and enforcing requirements that ensure TLACs absorb losses and prevent both bailouts and the collateral damage of failure is very difficult. It is baffling that regulators have taken this complex and unreliable approach to the problem of “too big to fail” banks when a much superior alternative is available. For the purpose of the regulation, a better approach is simply to insist that financial institutions rely much more on equity funding, i.e., to replace TLACs with equity. There is no sense, from society’s perspective, in which using non-equity forms of funding to absorb losses is cheaper or more effective than using equity for this purpose. Arguments that equity is more “expensive” in this context are based on fallacious or flawed reasoning.

Of course, it is better if banks use debt that can in principle absorb losses instead of secured short-term debt that cannot. Advocates of TLACs and other debt-like loss-absorbing

securities argue that such securities provide resolution authorities with cushions that would convert into equity. But if equity is used instead of these securities then it is less likely that resolution would be reached at all, which is even better.

Even under the new Basel III framework, banks are allowed to have as little as 3 percent of their assets funded with equity. The tough US leverage ratio requirement is 5 percent for the largest institutions. Such levels are inefficient and dangerous for any company; just because banks can borrow as much under attractive terms does not change the fact that their current funding mix is plainly harmful. With the rest of the funding in the form of deposits or short-term debt that needs frequent renewal, there is no need and no justification to allow such little equity and to replace any of it with debt of any sort. Loss-absorbing debt is simply a source of funding and not part of the business of banking, as deposits are. When taking on deposits and more debt, however, banks must be able to absorb more of their losses without needing supports. Equity can help them achieve more self-sufficiency at the appropriate prices in the equity markets that other companies must face.

Capital regulations are mainly based on assigning “risk weights” to assets in an attempt to calibrate the requirements to the risks of the banks’ investments. The use of risk weights has increased the fragility and interconnectedness of the system and added distortions to banks’ investments, generally biasing them away from business loans that the economy needs most. Risk weights are also complex and manipulatable and rely on models that can greatly concentrate or underestimate risks. Research has shown that measures of strength based on simple, unweighted leverage ratios are more predictive of banks’ ability to withstand shocks than ratios based on risk weights.

A major problem with capital requirements is the opacity and risk in derivatives markets. Neither investors nor regulators are able to understand or control these risks without better disclosures. Moving some derivatives trading to clearinghouses has the potential to provide more information, but clearinghouses have themselves become highly systemic. What will happen in the event of a default of one or more major firms is entirely unclear and should be of great concern, because opacity and fragility in these markets can easily transform even small shocks into system-wide disruptions. It is difficult to design effective regulations, including equity and margin requirements, unless the opacity is reduced so the risks can be evaluated and understood better.

Banks routinely threaten that they will be unable to lend if capital requirements are increased. However, this claim is immediately contradicted by the observation that as they make this claim,

banks make payouts to their shareholders, even though this money could be used to make loans and other investments, the profits of which would belong to shareholders as long as debts are paid. Moreover, if banks have worthy investments to make, including loans, they should be able to use equity funding to make these investments, just as other companies in the economy often do. Capital regulations do not prevent banks from investing their earnings or any equity funding they have raised. To the contrary, new equity allows banks to borrow at least 10 times more money, all of which can be used to make loans.

We are also told that passing periodic stress tests means that banks are “safe enough” and should be allowed to make payouts to their shareholders. But the stress tests set inappropriate benchmarks for passing and, just like the living wills, are not based on enough information about the system that allows reliable predictions of what would actually happen in stress events. The regulatory capital ratios of institutions that failed or needed supports during the financial crisis were often adequate. The true distress was seen more clearly in the market value of their equity, yet stress tests are incapable of reliably predicting complex market dynamics likely to be relevant in stress situations. Despite the enormous costs of the stress tests for banks and for regulators, they can be dangerous by giving a false sense of security.

Some argue that the financial crisis was primarily due to banks’ liquidity problems—i.e., their inability to convert their assets to cash and satisfy their debt commitments. In discussing prudential regulations, capital and liquidity requirements are often lumped together as if they are the same; indeed, many think that capital is something banks must “set aside” like a rainy-day fund, which is false. Capital and liquidity requirements are, in fact, quite different and present entirely different cost and benefit considerations.

Whereas capital requirements seek to control how banks fund their investments in light of their risks and how they can best absorb losses on their investments without harming the rest of the economy, liquidity requirements restrict the investments banks can make in an attempt to make sure that they can pay their debts when the debts are due. The Liquidity Coverage Ratio (LCR) in particular requires that banks have sufficient “liquid assets” to be able to cover normal withdrawals or debt payments for a period of 30 days.

But assumptions about which assets should be considered liquid “enough”, the value of those assets when sold, and how much debt is withdrawn or can be renewed in 30 days may all turn out to be wrong. Assets considered safe and liquid can suddenly

turn quite risky and illiquid. Liquidity requirements of this sort are costly by constraining banks' investments, and ultimately their benefits are questionable as they can fail to deliver these benefits exactly when they are needed the most. Banking institutions actually have a significant ability to draw liquidity supports from central banks, thus pure liquidity problems are easy to solve.

Having more equity in financial institutions actually reduces the likelihood of them running into liquidity problems because they have fewer debt claims and because their creditors trust them more and are thus less likely to withdraw funding. Moreover, with more equity, a given percentage loss in the asset does not translate into as high a fraction of the equity, thus the intensity of any asset sale and any of the "cyclicality" associated with regulation is reduced. Thus, higher equity requirements bring enormous benefits. And contrary to industry narratives, all they do is rearrange financial claims so as to prevent banks from passing some of their costs to others. They are not associated with any relevant cost to society. They only correct current distortions and make the system safer and better able to support the economy.

Designing and enforcing effective financial regulation is extremely challenging, but it is essential. To make progress, however, policymakers first must acknowledge that they know too little about the risks in the opaque and complex system to be able to assure us that it is "safe enough". Then they must take steps to reduce the opacity of the system and counter the distorted incentives for recklessness within it.

Policymakers must do a better job protecting the public and preventing banks from abusing their outsized privileges. Otherwise, the distortions and fragility in the financial system persist, increasing the odds of another costly financial crisis.

More information on the subject can be found [here](#)

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